No. 77-648

In the Supreme Court of the United States

OCTOBER TERM, 1977

FEDERAL ENERGY REGULATORY COMMISSION,
PETITIONER

v.

PENNZOIL PRODUCING COMPANY, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

REPLY MEMORANDUM FOR THE FEDERAL ENERGY REGULATORY COMMISSION

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1. Respondents contend[1] that the Commission's authority to pass through to interstate customers royalty costs based on the unregulated price of natural gas was established by this Court in *Mobil Oil Corp.* v. *Federal Power Commission*, 417 U.S. 283, affirming *Placid Oil Co.* v. *Federal Power Commission*, 483 F. 2d 880 (C.A. 5). The contention is erroneous. In the orders under review in those cases, the Commission established just and reasonable rates for natural gas produced from the Southern Louisiana Area. The royalty issue was only one

[1]Pennzoil Br. in Opp. 6-8; Shell Br. in Opp. 3-5; United Gas Pipe Line Br. in Opp. 5-7.

of numerous issues considered by the Commission[2] and reviewed by the courts in that proceeding. The Commission found the issue to be premature in the context of the area rate proceeding. The court of appeals agreed with the Commission, finding specifically (483 F. 2d at 911; emphasis in original):

> [W]e are not willing to alter or stay the implementation of area wide rates for the entire industry merely on the basis of what *might* happen to *some* producers' costs *if* this statement of the law prevails.
>
> If, as subsequent events develop, the producers are put in a bind by their royalty obligations, they [might] certainly petition FPC for individualized relief. * * * [W]e find it to be far preferable to speculative prophesies of future royalty components. If the royalty obligations are such as to make the rates established by Op. 598, and approved by us here, confiscatory or otherwise inappropriate, those producers who are materially affected will certainly have recourse to the administrative process.

This Court fully agreed "with the Court of Appeals that Mobil's argument is hypothetical at this stage and that in any event an affected producer is entitled to seek individualized relief." 417 U.S. at 328.

It is thus clear that the Commission and the courts in *Mobil* expressly declined to decide the merits of the principal issue presented in this case, which they viewed as premature. The observation of this Court and the court of appeals in *Mobil* that producers might seek individualized relief from the Commission when and if the issue became

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[2]See Opinion No. 598, 46 F.P.C. 86, rehearing denied, Opinion No. 598-A, 46 F.P.C. 633.

ripe—which is exactly what has happened in this proceeding—cannot be taken as expressing a view on the merits of such a claim for relief, especially when the courts noted that the merits were not ripe for decision.

2. Respondents also contend[3] that their increased royalty payments, which the Commission said it could not permit them to pass through to interstate customers, were not based on the unregulated intrastate market price because the amount of the royalties to be paid resulted from a negotiated settlement agreement. That claim ignores the essential fact that it was the claim by the lessor Williams for higher royalty payments based on the "market value" royalty clause in the oil and gas leases that led to the lawsuit, the settlement negotiations, the settlement, and the Commission proceedings. As the Commission observed in its opinion, the "impetus of the settlement is the market value of the royalties and no consideration has been given to regulated rates" (Pet. App. D, p. 22a). If we are correct that passing through to interstate customers royalty costs based on the intrastate market price of gas is contrary to the fundamental scheme of the Natural Gas Act and the principles established in *Federal Power Commission* v. *Texaco, Inc.*, 417 U.S. 380, parties should not be able to compel a different result by mutually agreeing on a royalty cost that is somewhat less than the lessor's original "market value" claim.

3. Respondents attempt to distinguish *Texaco, supra,* on two bases. First, they argue that in *Texaco* the Commission had attempted to regulate prices for certain sales in interstate commerce solely by reference to the unregulated market price. Because in the instant case only

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[3]Pennzoil Br. in Opp. 3-4; Shell Br. in Opp. 3, n. 3.

a percentage of the otherwise just and reasonable rate is affected by the higher royalty costs, respondents contend that *Texaco* is not in point.[4] As a factual matter, the contention is incorrect. As we pointed out in our petition (Pet. 12-13), what this Court rejected in *Texaco* was the Commission's attempt to permit pipelines and large producers to pass through to interstate customers one of many components of their costs—namely, the price they paid to small producers for gas, which was an unregulated price. In any event, for purposes of the Commission's obligation under the Natural Gas Act to allow only rates that it determines to be "just and reasonable," it makes no difference whether all or only a portion of the interstate rate is to be determined by the unregulated price of gas. As the Court said in *Texaco* (417 U.S. at 399), "the Act * * * does not say a little unlawfulness is permitted."

Second, respondents attempt to evade the principles set forth in *Texaco* by arguing that royalty costs are no different from any other costs that producers pass on to the consumer, such as drilling costs or the costs of labor. Respondents reason that just as the Commission has no jurisdiction or control over such cost items, so it has no jurisdiction over royalty costs and is obligated to pass them on to the interstate consumer. The flaw in this argument is that the royalty costs in this case have been established by reference to the unregulated market price of the very commodity that Congress has made the subject of regulation. In contrast to the costs of labor, steel, or other elements of production, the possibility that royalty payments could be based on the unregulated price of natural gas creates the type of regulatory "gap" that

[4]Pennzoil Br. in Opp. 9-10; Shell Br. in Opp. 2-3; United Gas Pipe Line Br. in Opp. 9.

this Court has consistently found unacceptable. *E.g.*, *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672, 682-684.

4. Finally, in contending[5] that the authority of the Commission to permit abandonment of "royalty gas" is not an issue in this case, respondents have misconceived the second issue presented by the petition. There is, of course, no question that the Commission has authority under Section 7(b) of the Natural Gas Act, 52 Stat. 824, as amended, 15 U.S.C. 717f(b), to permit abandonment of an interstate service of supply gas if it finds, as that section requires, either that the supplying of gas has been "depleted to the extent that the continuation of service is unwarranted" or that "the present or future public convenience or necessity permits such abandonment." Here the Commission's determination that the public convenience and necessity did not permit respondents to abandon "royalty gas" to their lessor in lieu of passing through "market value" royalty costs was essentially a corollary of its conclusion that the basic scheme of the Natural Gas Act does not permit the pass-through of market value royalty costs. The issue of the Commission's authority to permit abandonment of "royalty gas" in the circumstances of this case is therefore directly related to

[5]Pennzoil Br. in Opp. 13-14; Shell Br. in Opp. 5-7; United Gas Pipe Line Br. in Opp. 12-14.

the first issue presented in the petition, and is squarely presented by the decision below.

Respectfully submitted.

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